DOCUMENT RESUME

ED 364 131 HE 026 927

AUTHOR Morra, Linda G.
TITLE [Higher Education Assistance Foundation (HEAF) 1992 Financial Condition.]
INSTITUTION General Accounting Office, Washington, D.C. Div. of Human Resources.
REPORT NO GAO-HRD-93-21R
PUB DATE Jun 93
NOTE 10p.; For a related document, see ED 353 881.
PUB TYPE Reports - General (140)

EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS Cost Effectiveness; Credit (Finance); Educational Finance; Federal Government; Federal Programs; Higher Education; *Loan Default; Loan Repayment; Paying for College; *Program Costs; *Program Termination; Student Financial Aid; Student Loan Programs
IDENTIFIERS *Higher Education Assistance Foundation

ABSTRACT

This letter report by the Director of Education and Employment Issues in the U.S. General Accounting Office responds to a request from Senator Edward M. Kennedy for information on the federal costs involved for liquidation activities of the Higher Education Assistance Foundation (HEAF) in fiscal year (FY) 1992, the second year of the agreement to liquidate this institution. It explains how the federal government's net costs for the HEAF liquidation in FY 92 were $6.9 million and discusses potential costs during the institution's final year, FY 93. The report lists several factors that will increase HEAF's costs in FY 93, factors affecting the government's ability to recover costs, and ways in which the Department of Education's calculations differ from those of the General Accounting Office. It reports that among the factors increasing costs for FY 93 are: (1) $1.1 million in severance payments to HEAF employees; (2) an estimated $4.5 million payment to collection agencies for HEAF-guaranteed loans; (3) a final payment of about $7.8 million to Sallie Mae for managing HEAF during the liquidation; and (4) the establishment of a contingency reserve fund. The department's ability to offset increasing costs are seen to depend on the cumulative federal costs of the HEAF liquidation at year's end, the size and characteristics of the portfolio of loans, and the amount of collection penalties. (GLR)

****
* Reproductions supplied by EDRS are the best that can be made *
* from the original document. *
****

HE

GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

ED 364 131

B-249252

June 18, 1993

U.S. DEPARTMENT OF EDUCATION
Office of Educational Research and Improvement
EDUCATIONAL RESOURCES INFORMATION CENTER (ERIC)
☑ This document has been reproduced as received from the person or organization originating it
☐ Minor changes have been made to improve reproduction quality
• Points of view or opinions stated in this document do not necessarily represent official OERI position or policy

The Honorable Edward M. Kennedy
Chairman, Committee on Labor
and Human Resources
United States Senate

Dear Mr. Chairman:

In November 1992, we reported that the Department of Education's agreement to liquidate the Higher Education Assistance Foundation (HEAF) cost the federal government $212.4 million during fiscal year 1991.[1] This letter responds to your request for information on the federal costs for liquidation activities in fiscal year 1992, the second year of the liquidation agreement. We are including information about factors that have and will affect HEAF's financial position in 1993, as well as the government's ability to recover its costs after the HEAF liquidation is completed on December 31, 1993. It will be several years, however, before the net federal costs or income resulting from the HEAF liquidation can be finally determined.

BACKGROUND

The Federal Family Education Loan Program helps students obtain financial assistance to pay for their postsecondary education. Loans are made by entities such as commercial lenders and savings and loan institutions. Each state establishes a guaranty agency or designates another entity to carry out guaranty agency functions on behalf of the state. These functions include, among other things, guaranteeing repayment of student loans to participating lenders in the event of default or other circumstances described in the statute. HEAF was the designated guarantor in the District of Columbia, Kansas, Minnesota, Nebraska, West Virginia, and Wyoming. In

[1] Guaranty Agency Solvency: Can the Government Recover HEAF's First-Year Liquidation Costs of $212 Million? (GAO/HRD-93-12BR, Nov. 13, 1992).

HE 026 927

BEST COPY AVAILABLE

addition, HEAF was one of two national or multistate guarantors guaranteeing loans in other jurisdictions.

After the Department of Education reinsures (that is, pays) a guaranty agency for a default claim, the agency retains the defaulted loan and continues to try to collect it from the defaulting student-borrower. During each fiscal year, the amount of reinsurance an agency receives depends on the amount of its default claim payments. When an agency's default claims exceed 5 percent, but not more than 9 percent, of the principal amount of loans that it guaranteed and that were in repayment at the end of the previous fiscal year, the agency is reimbursed at 90 percent. If an agency's defaults exceed 9 percent of guaranteed loans, it is reinsured at 80 percent. At the beginning of each fiscal year, Department reimbursements for defaults return to 100 percent and remain so until an agency's default claims exceed the 5-percent threshold.

The amount that a guaranty agency subsequently collects from a defaulting borrower is distributed as follows: If an agency receives less than 100 percent when the Department paid reinsurance on the claim, the agency retains the portion of the default collection that the Department did not reimburse. The agency also retains 30 percent of total collections to help offset collection costs and forwards the remaining amount to the Department. For example, assume that (1) the Department reimbursed an agency for a $100 defaulted loan at the 80-percent reinsurance rate and (2) the agency subsequently collected $100 from the borrower. The agency retains $20 for which it was not reimbursed and $30 (30 percent of $100) to offset collection costs; the agency forwards the remaining $50 to the Department.

In June 1990, HEAF--which at the time was the largest loan program guarantor--notified the Department of its serious financial problems and its anticipated inability to pay lenders' claims. Because of the high rate of default on its guaranteed loans, HEAF was eligible for only 80-percent reimbursement on many of its loans, although it was paying lenders 100 percent for their losses. On October 31, 1990, a liquidation agreement was reached--between the Department; the Student Loan Marketing Association (Sallie Mae); and Minnesota Guarantor Servicing, Inc., a Sallie Mae subsidiary--on how to resolve HEAF's financial problems.

The agreement provides for the Department to reimburse HEAF 100 percent of all defaulted loan claims it submits to the Department, regardless of whether defaults exceed the 5- and 9-percent thresholds. The Department also agreed to allow HEAF to retain all collections on its defaulted loan portfolio until December 31, 1993, or until the Department and Sallie Mae agree that HEAF has sufficient assets to meet expected expenditures and to establish a contingent liability reserve fund to pay any claims made against HEAF after the agreement terminates. On December 31, 1993, HEAF'S net assets, including its portfolio of defaulted loans, are to be turned over to the Department.

SCOPE AND METHODOLOGY

As in our November 1992 report, we defined the federal costs of the HEAF liquidation as those costs that would not have been incurred had HEAF continued to operate as a normal guaranty agency. In fiscal years 1991 and 1992, the principal federal costs were (1) reinsuring all HEAF-guaranteed defaulted loans at the 100-percent rate rather than the 90- and 80-percent rates that would have otherwise applied to a portion of HEAF defaults, and (2) allowing HEAF to retain all collections from defaulted loans for which the Department had paid reinsurance rather than paying approximately 65 percent of those collections to the Department. In fiscal year 1992, HEAF would have retained an average of about 35 percent (rather than 30 percent) of its collections because some of its loans were reinsured at less than 100 percent.

To determine fiscal year 1992 liquidation costs, we analyzed selected HEAF financial data and Department payment records for defaulted loans guaranteed by HEAF. We interviewed HEAF and Department officials to obtain additional information about financial events in fiscal year 1992 and costs expected before HEAF's liquidation at the end of 1993.

RESULTS IN BRIEF

The federal government's net costs for the HEAF liquidation in fiscal year 1992 were $6.9 million. Although HEAF's assets increased by $138.3 million during fiscal year 1992, its costs were $145.2 million. Several one-time events affected HEAF finances in 1992. Most important, HEAF affiliates forgave $46.5 million in loans

that HEAF was unable to repay. This was partially offset by HEAF's forgiving $2.3 million it was owed by two of the affiliates. Also, HEAF paid $7 million to shorten its building lease. Without these unique transactions, the government's costs in fiscal year 1992 could have been $44.1 million.

Before the liquidation is completed in 1993, several factors will most likely increase HEAF's, and thus ultimately the government's, costs under the liquidation agreement. For example, Sallie Mae will receive its final payment for managing the HEAF liquidation. The Department's ability to offset the cumulative costs of the liquidation after December 1993 will depend on several factors, including (1) the size and characteristics of the portfolio of defaulted loans the Department receives from HEAF and (2) how efficiently and effectively the Department collects those loans.

FEDERAL COSTS IN FISCAL YEAR 1992 WERE NEARLY OFFSET BY AN INCREASE IN HEAF ASSETS

Federal costs for the HEAF liquidation were $145.2 million in fiscal year 1992. During that year, HEAF's assets increased by $138.3 million, which will reduce net costs because all HEAF assets will be turned over to the Department at the end of 1993.

As shown in table 1, the federal cost of paying HEAF 100 percent reinsurance for its default claims was $40.6 million during fiscal year 1992. Normally, reinsurance payments to agencies decline when an agency's annual default rate exceeds statutory thresholds. The liquidation agreement, however, requires that the Department pay HEAF 100 percent of all its default claims, without regard to the thresholds.

Table 1: Federal Costs for HEAF Liquidation (Fiscal Years 1991 and 1992)

Dollars in millions

	1991	1992	Cumulative
Additional reinsurance paid by the Department of Education	$138.8	$40.6	$179.4
Retention of current-year loan collections	78.2	104.6	182.8
Retention of 1990 loan collections and other funds due the Department	35.4	a	35.4
Total costs	$252.4	$145.2	$397.6
Less increase in HEAF net assets to be turned over to the Department	40.0	138.3	178.3
Net federal costs	$212.4	$6.9	$219.3

[a]Not applicable for fiscal year 1992, as HEAF's retention of 1990 funds due the Department affected only fiscal year 1991's costs.

As allowed by the liquidation agreement, HEAF retained all of the $160.9 million it collected on defaulted loans during fiscal year 1992. Without the agreement, HEAF would have paid the Department approximately 65 percent of reinsured loan collections and retained about 35 percent.[2] This provision of the agreement, therefore, cost the federal government $104.6 million in 1992.

HEAF's net assets increased from $40 million in fiscal year 1991 to $178.3 million in 1992. Thus, the Department's costs for additional reinsurance payments and HEAF's retention of loan collections in fiscal year 1992 ($145.2 million) were nearly offset by the $138.3

[2]A HEAF official estimated that about 65 percent of HEAF's total collections would normally have been paid to the Department in fiscal year 1992. This is a weighted estimate.

million increase in HEAF's net assets, resulting in a net federal cost of $6.9 million.

UNIQUE TRANSACTIONS FAVORABLY AFFECTED HEAF'S FINANCES

Several one-time transactions accounted for $37.2 million of the $138.3 million increase in HEAF's net assets in fiscal year 1992. As specified in a pre-existing mutual support agreement, two former HEAF affiliates, which were lenders in secondary markets, forgave $46.5 million of demand notes (loans) that HEAF owed them but was unable to repay because of its financial situation. This increase in HEAF's assets was partially offset by HEAF's forgiving $2.3 million it was owed by the two former affiliates and by HEAF's paying $7 million to shorten its commitment to a building lease.

In the absence of these transactions, which in total favorably affected HEAF's financial condition, the net federal costs for the liquidation would have been $44.1 million in fiscal year 1992.

SEVERAL FACTORS WILL INCREASE HEAF'S COSTS IN 1993

HEAF officials anticipate several onetime costs before the liquidation of HEAF is completed on December 31, 1993. These include

-- about $1.1 million in severance payments to HEAF employees;

-- an estimated $4.5 million payment to collection agencies for HEAF-guaranteed loans that these agencies brought back into repayment and that HEAF will turn over to the Department for continued collection after December 31, 1993;

-- the final payment of about $7.8 million to Sallie Mae for managing HEAF during the liquidation; and

-- the establishment of a contingency reserve fund, the amount of which has yet to be determined, to cover HEAF obligations remaining after December 31, 1993.

We do not know what the total financial impact of these and other factors, as yet unknown, will have on the government's total costs for liquidation.

GOVERNMENT'S ABILITY TO RECOVER COSTS DEPENDS ON SEVERAL FACTORS

The Department's ability to offset the $219.3 million in HEAF liquidation costs incurred through fiscal year 1992, as well as any additional costs incurred before December 31, 1993, will depend on (1) the cumulative federal costs of the HEAF liquidation on December 31, 1993, (2) the size and characteristics of the portfolio of loans the Department receives from HEAF and how efficiently and effectively it can collect the loans, and (3) the amount of collection penalties it assesses and collects in addition to what HEAF would have assessed and collected on defaulted loans.

Neither we, the Department, nor HEAF has developed estimates for the government's net cost or income related to the HEAF liquidation, and the Department said that it will be several years before this can be done. After receiving HEAF's loan portfolio by December 31, 1993, the Department plans to evaluate the portfolio and project the income and expenses from the liquidation. Also at that time, HEAF plans to develop a position paper on the costs, benefits, and lessons learned from the liquidation.

DEPARTMENT OF EDUCATION DIFFERS WITH OUR CALCULATION OF HEAF LIQUIDATION COSTS

The Department of Education has four primary concerns with how we calculated the costs to the federal government related to the liquidation of HEAF.

1. In both this and our November report, we define the federal costs of the HEAF liquidation as those costs that would not have been incurred had HEAF continued to operate and conduct normal guaranty functions. The Department maintains that since HEAF was unable to operate as a normal guaranty agency, it had to pay 100 percent reinsurance on HEAF-guaranteed loans. The Department said its choice was to pay 100 percent reinsurance either to HEAF under the liquidation agreement or to some other party that would have taken over HEAF's operations. Thus, the Department

does not consider additional reinsurance paid to HEAF to be a cost of the liquidation.

While from a practical standpoint the Department believed it needed to pay 100 percent reinsurance for HEAF-guaranteed loans, it was not required to make such payments at the time HEAF was failing. It chose to pay 100 percent reinsurance on all these loans to ensure that lenders would receive 100 percent insurance on their HEAF-guaranteed defaulted loans. Notwithstanding that paying additional reinsurance was an unavoidable cost of maintaining lender confidence in making guaranteed student loans, these payments were clearly federal costs of the HEAF liquidation.

2. The Department contends that when we consider HEAF's retention of the full amount of loan collections as a federal cost, our analysis assumes that the collections are forever lost to the government. (Under the liquidation agreement, HEAF retains all collections until the end of the agreement or until the Department and Sallie Mae agree that HEAF has sufficient assets available to meet expected expenditures and to establish a contingent liability reserve. At that time, they are turned over to the government with its other assets.) However, these collections are included in HEAF's assets. In our analysis, we deducted the annual increase in HEAF's net assets (including loan collections retained by HEAF) from the annual federal cost of the liquidation, therefore capturing the impact of loan collections retained by HEAF.

3. The Department maintains that our analysis does not include the benefits it will receive from uncollected defaulted loans that it will acquire from HEAF at the conclusion of the liquidation agreement. Both of our reports focused on the Department's costs of the HEAF liquidation for a single fiscal year. We recognize that some unknown amount of uncollected defaulted loans will be collected by the government and will reduce the net federal costs of the liquidation. But we, the Department, and HEAF are unable to determine what will be the future net federal costs or income from the liquidation.

4. After we issued our November report, the Department stated that it did not believe that our consideration of fiscal year 1991 expenses alone would be helpful in assessing the costs of the liquidation. In our earlier work, our analysis was focused--in part, limited by the financial information available--on the first year (fiscal year 1991) of the liquidation agreement. This report expands on our earlier analysis. Together the two reports provide a more comprehensive assessment of the federal costs of the liquidation through fiscal year 1992. However, it will be several years before the federal government's final net costs or income resulting from the HEAF liquidation can be determined.

- - - - -

We did our work between February and May 1993 in accordance with generally accepted government auditing standards.

We are sending copies of this letter to the Secretary of Education and the president of Sallie Mae. We will also provide copies to other parties upon request.

Should you wish to discuss this information further, please call me on (202) 512-7014.

Sincerely yours,

Linda G. Morra
Director, Education and
Employment Issues

(104745)